



Appeal of Shachihata, Inc., U.S.A.

The issue for determination is whether the operation of appellant and its Japanese parent constituted a single unitary business.

Appellant was incorporated under the laws of California on November 7, 1968, and began doing business in this state on that date. Appellant is a wholly owned subsidiary of a Japanese corporation, Shachihata Industrial Company, Ltd. (hereinafter referred to as parent). Appellant and its parent are a vertically integrated operation; appellant wholesales merchandise manufactured by its parent.

Appellant wholesales pre-inked rubber stamps, marking pens and multi-edged blade cutters. It purchases **approximately** 81 percent of its inventory, consisting of its entire inventory of stock items, directly from its parent. Appellant manufactures **approximately** 19 percent of its **remaining** inventory which consists entirely of custom items. Some of the materials used to manufacture the custom items are purchased from parent. Appellant's merchandise is marketed under the brand names "X-STAMPER" and "ARTUNE". The parent uses a Japanese equivalent to the brand name "X-STAMPER". Appellant's merchandise is sold to stationery stores, office supply houses and the federal government on a nationwide basis.

All of appellant's stock is owned by its Japanese parent. During the appeal years appellant had three directors who were also directors of the parent. The three directors were also officers of both appellant and its parent. All three lived and worked in **Nagoya**, Japan. Appellant also had two additional officers who were responsible for major policy decisions. They were its treasurer, Mr. Nomura, and its secretary, **Mr. Yamada**. **Mr. Nomura** was also employed by the parent in Japan where he resided. **Mr. Yamada** resided in the United States and was primarily responsible for appellant's day-to-day operations. In the event of a disagreement between appellant's management and the parent, the parent exercised ultimate control.

Appellant had a \$500,000 line of credit with a California bank which was guaranteed by its parent. Some personnel were transferred from the parent to appellant for periods of up to six months for training purposes. **Appellant** also shared a common pension plan with its parent.

When a taxpayer derives income from sources both within and without California, it is required to **measure its California franchise tax liability by its**

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net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business with an affiliated corporation, the amount of income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (See Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16] (1947); John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214 [238 P.2d 569] (1951), app. dismissed 342 U.S. 939 [96 L. Ed. 1345] (1952).)

The California Supreme Court has determined that a unitary business is definitely established by the existence of: (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in a centralized executive force and general system of operation. (Butler Bros. v. McColgan, 17 Cal. 2d 664, 678 [111 P.2d 334] (1941), aff'd., 315 U.S. 501 [86 L. Ed. 991] (1942).) The court has also held that a business is unitary when the operation of the business within California contributes to or is dependent upon the operation of the business outside the state. (Edison California Stores, Inc. v. McColgan, *supra*, 30 Cal. 2d at 481.) These principles have been reaffirmed in more recent cases. (Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33] (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 40] (1963).)

The existence of a unitary business may be established if either the three unities or the contribution or dependency test is satisfied. (Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) Implicit in either test, of course, is the requirement of quantitative substantiality. (Appeal of Beatrice Foods Co., Cal. St. Bd. of Equal., Nov. 19, 1958; Appeal of Public Finance Co., Cal. St. Bd. of Equal., Dec. 29, 1958; see also Superior Oil Co. v. Franchise Tax Board, *supra*.) In other words, corporations are engaged in a **unitary business within the scope of either test** if, because of the unitary features, the earnings of the group are materially different from what they would have been if each corporation had operated without the benefit of its unitary connections with the other corporation.

In concluding that **appellant** and its parent were engaged in a single unitary business under either the contribution and dependency or the three unities test, respondent relied on the following factors: an integrated

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executive force which controlled appellant's major policy decisions; total ownership of appellant by its parent; substantial **intercompany product** flow resulting from the vertical integration of parent and appellant which created a guaranteed source of all of **appellant's** stock merchandise and a guaranteed demand for the parent's stock merchandise: intercompany financing through parent's guarantee of appellant's \$500,000 line of credit; intercompany personnel transfer for training purposes; and a common pension plan. In numerous prior cases the unitary features relied upon by respondent, when viewed in the aggregate, have demonstrated a degree of mutual dependency and contribution sufficient to compel the conclusion that a unitary business existed. (See, e.g., Chase Brass & Copper Co. 'v. Franchise Tax Board, 10 Cal. App. 3d 496 [87 Cal. Rptr. 239], app. dismiss. and cert. den., 400 U.S. 961 [27 L. Ed. 2d 381] (1970); Appeal of Beecham, Inc., Cal. St. Rd. of Equal., March 2, 1977; Appeal of Grolier Society, Inc., Cal. St. Rd. of Equal., Aug. 19, 1975; Appeal of F. W. Woolworth Co., supra; Appeal of Public Finance Co., supra.)

Respondent's determination that appellant is engaged in a unitary business with its parent is presumptively correct and the burden to show that such determination is erroneous is upon appellant. (Appeal of John Deere Plow Co. of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) Although appellant contends that, as a matter of fact, appellant is not unitary with its parent, it has offered no factual evidence in support of its position. Thus, in the absence of some compelling reason to invalidate respondent's determination, we must conclude that **appellant** has failed to carry its burden of proof and that respondent's action in this matter was correct.

In support of its position challenging the assessments, appellant advances four constitutional arguments: (1) The tax is measured in part by the income of the foreign parent which is contrary to the due process clause of the Fourteenth Amendment to the **United States** Constitution; (2) Assuming the existence of a unitary business, a combined report of the foreign parent and the domestic subsidiary cannot be mandated under the due process and commerce clauses of the United States Constitution; 1/ (3) Requiring a combined return by appellant

1/ In summary, the thrust of appellant's argument on this point is that a combination of foreign-based currency financial statements and dollar-based currency statements

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and its Japanese parent violates the Treaty of Friendship, Commerce and Navigation (4 U.S.T. 2063 (April 2, 1953)) between the United States and Japan as well as the Convention between the United States and Japan for the Avoidance of Double Taxation (23 U.S.T. 967 (March 8, 1971)); 2/ and (4) ~~Assuming~~ the existence of a unitary business, the formula used for the computation of the amount of income allocable to California does not bear a rational relationship to the peculiarities of the two corporations and is constitutionally invalid.

This board. has a well established policy of abstention from ~~deciding~~ constitutional questions in an appeal involving proposed assessments of additional tax. (Appeal of Maryland Cup Corp., Cal. St. Bd. of Equal., March 23, 1970; Appeal of Humphreys Finance Co., Inc., Cal. St. Bd. of Equal., June 20, 1960; see also Cal. Const. art. III, § 3.51) This policy is based upon the absence of any specific statutory authority which would allow the Franchise Tax Board to obtain judicial review of a decision in a case of this type, and our belief that such review should be available for questions of constitutional importance. This policy properly applies to the instant appeal and disposes of the only remaining issues raised by appellant. Accordingly, respondent's action in this matter must be upheld.

1/ (Cont.) arrives at an inherently faulty result. The income shown as being apportioned to California is neither income based upon United States currency n'or income based upon a foreign currency. A combined report requires a translation - not expression - of the foreign parent's financial data into United States dollars. An accurate translation, however, is an economic impossibility even if there were established rules for perfecting the translation, which there are not. Therefore, appellant concludes that the tax, as computed, places an undue burden on foreign commerce which does not similarly apply to domestic commerce due to the uniform measure of domestic currency and is unconstitutional.'

2/ Although not framed in constitutional terms, the substance of appellant's argument is that the method of taxation at issue violates certain treaty obligations of the United States and is therefore invalid under the supremacy clause of the United States Constitution (art. 171, ch. 2). (See Japan Line, Ltd. v. County of Los Angeles, 20 Cal. 3d 180, 188 [141 Cal. Rptr. 905, 571 P.2d 254] (1977), appeal docketed, 46 U.S.L.W. 3618 (U.S. March 28, 1978) (No. 77-1378).) We so treat it.

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O R D E R

! Pursuant to the views expressed in the opinion
of the board on file in this proceeding, and good cause
appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Shachihata, Inc., U.S.A., against proposed assessments of additional franchise tax in the amounts of \$1,562, \$3,181, \$4,975 and \$13,137 for the income years ended June 30, 1971, 1972, 1973 and 1974, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 9th day
of **January, 1979**, by the State Board of Equalization.

William B. Brown, Chairman
W. H. Kline, Member
_____, Member
Robert L. Frey, Member
_____, Member